

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of

1998 Biennial Regulatory Review—
Review of Depreciation Requirements for
Incumbent Local Exchange Carriers

CC Docket No. 98-137

United States Telephone Association
Petition for Forbearance From
Depreciation Regulation of Price Cap
Local Exchange Carriers

ASD 98-91

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SUMMARY

Depreciation prescription for LECs, and specifically for price cap LECs, is no longer in the public interest. To the extent that linkages between costs and prices remain, there are alternative measures for the Commission to utilize to ensure that carrier rates are just, reasonable and nondiscriminatory. For example, if a carrier must file for a low-end adjustment or if a carrier's Actual Price Index exceeds the Price Cap Index, the particular carrier, rather than the industry as a whole, should bear the burden of justifying its costs are reasonable.

If the Commission decides to preserve the depreciation prescription process, it must be modified. Filing and prescription procedures must be simplified and reporting requirements reduced. Equipment life ranges should be shortened. LECs should also be given the option of treating net salvage as either a current expense or a component of depreciation.

If the Commission is hesitant to eliminate depreciation prescription in its entirety, a middle-of-the-road approach would be to exempt mid-size LECs from the depreciation process. Such an exemption would provide the Commission with an ideal opportunity to monitor the effect of the absence of depreciation prescription to see if abuses materialize.

Finally, the Commission should grant the USTA's recently filed Petition for Forbearance from depreciation regulation. Depreciation regulation is no longer required to ensure just and reasonable charges and nondiscriminatory practices, and is therefore not in the public interest.

I. INTRODUCTION

The Commission's proposals in the NPRM are premised upon the assumption that regulatory oversight of depreciation is still necessary. The Commission's apparent justification for retaining regulatory oversight over price cap carriers' depreciation is the link between costs and prices that remains in several situations cited in paragraph six of the NPRM. Although there may still be some minimal connection between costs and prices in the specific situations cited, such a tenuous connection is not sufficient to warrant maintaining the complex depreciation process. There are alternative ways to address the few remaining instances where costs and prices remain linked.

The Commission asserts that, until there is robust competition in the local exchange markets, the depreciation prescription process cannot be eliminated.¹ CBT submits that, pursuant to the deregulatory, pro-competitive mandate of the 1996 Act, the Commission should not retain its depreciation prescription process for price cap LECs absent evidence that the benefits of retaining regulatory oversight exceed the costs. To subject all price cap LECs to the burdensome depreciation process because of the remote chance that some LEC may file for a low-end adjustment mechanism ("LFAM") or make an above-cap filing cannot be supported. As Commissioner Furchtgott-Roth suggested in his Separate Statement accompanying the NPRM, if depreciation regulation is to be retained, those who advocate retention should present a cost-benefit analysis as justification for retaining the regulation.

¹ See NPRM at para. 7.

A weighing of costs versus benefits is also embodied in the principles for biennial review outlined by the USTA in its Biennial Review Petition for Rulemaking.² CBT believes that a thorough cost-benefit analysis will demonstrate that depreciation prescription for all price cap LECs no longer serves the public interest. Instead, the public interest would be better served by following Commissioner Powell's advice and enforcing violations when they occur, rather than preserving a process based upon mere speculation about the anticompetitive effects that might occur.³ Short of adopting Commissioner Powell's advice on a large scale, CBT at least urges the Commission to eliminate the depreciation prescription process for mid-size LECs as a starting point, in order to determine if these perceived dangers actually occur.

II. COST-PRICE LINKAGES NO LONGER JUSTIFY DEPRECIATION PRESCRIPTION.

The Commission suggests that depreciation prescription is still required for price cap LECs because several cost-price linkages remain under the price cap rules. The linkages cited by the Commission are: 1) calculation of a LFAM; 2) recalculation of the productivity factor; 3) an exogenous cost determination; 4) calculation of the Base Factor Portion ("BFP"); and 5) cost support if a proposed Actual Price Index ("API") exceeds the Price Cap Index ("PCI"). Several of these cost-price linkages apply only in unique situations that rarely occur. In addition, alternative measures can be adopted to provide adequate Commission oversight, if necessary, to ensure that carrier rates are just, reasonable and not discriminatory.

² USTA Petition for Rulemaking – 1998 Biennial Regulatory Review, filed September 30, 1998 pp. 19-22.

³ Commissioner Michael K. Powell Speech Before the Independent Telephone Pioneers Association, May 7, 1998.

The LFAM appears to be the primary cost-price link that concerns the Commission. Until the Commission makes a commitment to allow access pricing flexibility and implements the universal service reforms that are necessary for competition to fully develop, this safeguard should be retained. However, since it is rarely utilized, there is no need to impose the burden of depreciation prescription on all price cap LECs, when most will never invoke the LFAM. Rather, as USTA suggested in its Petition for Forbearance, if a LEC invokes the LFAM, it should be required to provide the necessary support to justify that its depreciation rates have not been manipulated so as to affect its return. Construed in accordance with the USTA's suggestion, the depreciation process would properly place the burden only upon the LEC(s) impacted by the LFAM and not on all other LECs.

Another purported justification for retaining depreciation prescription is that cost support is necessary to justify an API higher than a carrier's PCI. As with the LFAM, it is rare that a carrier would make such a filing. Again, however, if a carrier is in such a situation, the individual carrier should bear the responsibility to justify that its costs (i.e., depreciation rates, etc.) are reasonable.

The other linkages cited in the NPRM also do not warrant continued regulation of depreciation, for a number of reasons. First, for mid-size LECs, there is no linkage between prescribed depreciation rates and the depreciation rates used in the last X-factor determination. No 2% mid-size LEC data was used in the last X-factor determination. Even if CBT's and other mid-size LECs' data had been used, it would have carried little weight due to the size differential of the RBOCs compared to the mid-size companies. In addition, the Commission has the final say as to what the input variables being utilized in

the X-factor determination are and how often the X-factor will be updated. Therefore, the Commission's concerns are exaggerated relative to the LECs' ability to manipulate depreciation rates in the X-factor determination.

Second, depreciation changes are considered to be endogenous and not exogenous by the Commission.⁴ Depreciation prescription is not listed in the Commission's rules as one of the eight areas that are currently considered to be exogenous adjustments.⁵

Lastly, the Commission's concern with the calculation of the BFP is not sufficient to prevent forbearance of depreciation prescription. As the Commission cites in the NPRM, at footnote 26, LEC BFP determinations are subject to the Commission's review. LECs submit BFP revenue requirement estimates. These estimates are subjected to intervenor review and Commission review. If something looks out of order, the Commission has the authority to suspend and investigate. Forbearing from depreciation rate setting does not impact this safeguard. In addition, with the access reforms enacted last year, price cap LECs are nearing the point where end user charges will be based on revenues instead of revenue requirements and the BFP becomes irrelevant.⁶

The Commission's concerns about the use of prescribed depreciation rates in universal service and forward-looking cost calculations are likewise misplaced. Rather than using prescribed rates in the universal service calculation, estimates of economic depreciation can be used. As far as the state interconnection proceedings are concerned (where forward-looking cost calculations must be made), pricing decisions for

⁴ See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, *Report and Order and Second Further Notice of Proposed Rulemaking*, FCC 89-91, (rel. April 17, 1989), at paras. 651-53.

⁵ See 47 C.F.R. 61.45(d).

⁶ See 47 C.F.R. 69.152.

interconnection and unbundled elements have been left to the states and they may choose their own approach to accounting for depreciation. Not all states are using the Commission's prescribed depreciation rates. Even if some states have chosen to rely upon the Commission's rates, this is not a sufficient reason for the Commission to continue to prescribe such rates.

III. IF DEPRECIATION PRESCRIPTION CONTINUES, THE PROCESS SHOULD BE VASTLY SIMPLIFIED.

Although CBT advocates the elimination of depreciation regulation by the Commission altogether, if the Commission decides to continue to prescribe depreciation rates, the process should be simplified as much as possible. CBT is concerned that some of the changes proposed in the NPRM are vague and raise several questions regarding the manner in which these changes would be implemented.

A. Filing and Prescription Procedures Should be Simplified.

The NPRM proposes that if carriers select depreciation factors from within the Commission-prescribed ranges, they need only file four summary exhibits and the electronic data files used to generate the exhibits. The NPRM is unclear regarding the electronic files. If the electronic files must still contain all of the historical data on which the Commission has typically relied, the benefit of the proposal is negligible. In order for the simplified procedures and reduced reporting requirements to have any significant effect, the ranges set by the Commission must reflect the economic realities faced by LECs. This means that the ranges must be updated to be more in line with the unregulated entities that are competing in the telecommunications market.

The NPRM proposal also requires that carriers “certify that their selections are consistent with their operations.”⁷ The vagueness of this language leaves considerable room for the Commission to impose additional filings by carriers that would offset any benefits that might otherwise be provided.

The additional depreciation prescription simplifications proposed in this NPRM raise other problematic questions, including: 1) Would ranges be created for Buildings and Aerial Wire accounts and what basis would the Commission use in the future to adjust the ranges to reflect changing market conditions? 2) Would accounts that are already prescribed with life or salvage values outside the Commission’s ranges be grandfathered? If so, how would this be accomplished? Would a carrier that has prescribed parameters outside the range be required to file a study to support these currently prescribed parameters? 3) What process would the Commission use to approve curve shape selections? Would the currently prescribed curve shapes be enforced or would carriers be permitted to submit new curve shapes? What data would be required to support the new curve shape selections? These questions and others need to be considered by the Commission when determining whether depreciation prescription is still warranted.

B. Equipment Life Ranges Should be Expanded Downward.

The NPRM proposes that the range for digital switching equipment be expanded from the existing range of 16 to 18 years to a range of 13 to 18 years. CBT submits that the proposed range is still too conservative and recommends that the lower bound be further decreased. For example, in *Transforming the Local Exchange Network*, a

⁷ NPRM at para. 10.

projected life range of 9 to 12 years is recommended for embedded digital switching equipment.⁸ Other ranges should also be reexamined.

C. Elimination of Net Salvage Should be Optional.

CBT agrees with the Commission's assessment that estimating future gross salvage and cost of removal is speculative. However, CBT does not advocate the mandatory elimination of the net salvage factor from the depreciation formula. Instead, it is more appropriate to allow LECs the option of treating net salvage as either a current expense or a component of depreciation. This optional approach is particularly appropriate given that accounting for the cost of removal is currently under review by the Financial Accounting Standards Board. Since this review may result in changes to the GAAP guidelines for net salvage, CBT believes it is premature for the Commission to adopt a mandatory change

Elimination of net salvage from the depreciation process presents a number of issues that would have to be resolved prior to implementation. Because net salvage is a component of the remaining life rate formula, future depreciation rates should be adjusted to reflect the removal of the net salvage component. For Outside Plant accounts, which traditionally have large negative net salvage components, the future rates would be lower than currently prescribed. However, the reduced depreciation expense would be offset by large cost of removal expenses in future accounting periods when the plant is displaced.

A process would have to be established to identify and account for net salvage embedded in the accumulated reserves. For each account, the embedded net salvage

⁸ See *Transforming the Local Exchange Network*, NPRM at footnote 41.

should be identified, with deficiencies netted against surpluses. A procedure would have to be established to account for the resulting surplus or deficiency.

IV. RELIEF FOR MID-SIZE LECS IS APPROPRIATE

The NPRM proposes that mid-size LECs, defined as LECs with aggregate revenues of less than \$7 billion, not be required to file annual theoretical reserve studies. Although CBT does not oppose the elimination of this annual study, CBT submits that the proposal does not go far enough. Clearly, as stated above, CBT believes that it is in the public interest for the Commission to forbear from depreciation regulation for all price cap LECs. However, should the Commission decide to continue such regulation, it should at least consider eliminating depreciation prescription for the 2% mid-size LECs.⁹

Under the current rules, carriers with revenues of less than \$112 million are not subject to the depreciation process. Of those carriers that are subject to the Commission's depreciation process, the largest LECs represent over 90 percent of the industry. The 2% mid-size LECs currently subject to the Commission's depreciation prescription process represent less than three percent of the industry and are dwarfed in size by the largest LECs.¹⁰ To create a new class of regulations for mid-size LECs is unnecessary and inappropriate. Instead, this is an ideal opportunity for the Commission, if it is at all hesitant to eliminate the depreciation prescription process for

⁹ Two- percent mid-size LECs, as defined in section 251(f)(2) of the 1996 Act, are those LECs with less than two percent of the nation's access lines.

¹⁰ CBT, for example, is only 1/39th the size of the current Bell Atlantic and with the mergers of SBC/Ameritech and Bell Atlantic/GTE will be only about 1/60th the size of these new telecommunications giants.

all LECs, to experiment with deregulation by exempting the mid-size LECs. Such an exemption would provide a controlled situation that the Commission can easily monitor to see if abuses materialize.

V. USTA'S PETITION FOR FORBEARANCE SHOULD BE GRANTED.

CBT endorses the USTA's Petition for Forbearance from depreciation regulation.

The USTA clearly demonstrates that forbearance would satisfy the requirements of section 10 of the Communications Act. Under the three-prong test of section 10, the Commission must forbear from applying any regulation if: (1) the regulation is not necessary to ensure that the carriers' charges, practices, classifications or regulations are just and reasonable and not unjustly or unreasonably discriminatory; (2) enforcement of the regulation is not necessary for the protection of consumers; and (3) forbearance is consistent with the public interest. As the USTA Petition demonstrates, depreciation regulation is no longer required to ensure just and reasonable charges and non-discriminatory practices, nor is it necessary for protection of consumers. With the elimination of sharing under the price cap rules, depreciation regulation is no longer necessary to control potential cost manipulation and, thus, serves no useful purpose. There is no public benefit realized by retaining the depreciation rules. In fact, the public interest will be better served by forbearance due to the corresponding elimination of the compliance costs incurred by both LECs and the Commission.

CBT also agrees with the USTA that granting forbearance from depreciation regulation should not preclude price cap LECs from recovering reserve deficiencies that exist as a result of past depreciation regulation. Recovery of these embedded regulatory assets should not be negated by prospective changes to depreciation practices.

VI. CONCLUSION

CBT urges the Commission, either through its Biennial Review or through the forbearance process, to eliminate depreciation regulation altogether. Under either standard, the requirements are satisfied for elimination of the depreciation regulations. Alternatively, if the Commission continues to prescribe depreciation rates, CBT believes the Commission should at least change the threshold for determining which carriers are subject to the depreciation prescription to exempt the 2% mid-size LECs.

Respectfully submitted,

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